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One foot in and one foot out...

What investors are ill advised to do...?

Before Lehman and After Lehman...

For investors, confusion reigns supreme. The era we're in could be described as a double mania; **Datamania** and **Opinionmania**. This was written in order to give investors a differing and unique view of the current economic and investment climate. It is intended as a view that you may not have seen or considered in the past.

First, I write **Datamania** because investors are inundated with data. In the media, each new data point is treated with urgency and instant interpretation. If we take into consideration every piece of data we get from every Government agency and private associations, economists, and financial services firms, we enter a state of paralysis from over analysis, a real Wall Street term, by the way. For news junkies (like myself), this is an extraordinarily interesting time. In every case, the interpretation of the data being reported is dependant upon the hopes and personal biases of those whom are commenting on the data. **Of course, the most useful interpretations are those based on ones experience and that are backed by real numbers.**

Second, I write **Opinionmania** because we're hearing hugely conflicting opinions on both the economy and the stock and bond markets. When listening/watching/reading the various financial related media sites, **we hear calls for new market lows that will crush investors followed immediately by calls for new market highs that will take investors' wealth to new heights.**

Third, everyone is entitled to their opinion and interpretation.

Alas, what's an investor to do now?

3 questions and the accompanying answers will address this question.

1. Which data point(s) is truly worth an open ear?

2. Who should we listen to?

3. Which investment decision(s) is the most prudent?

Number 1 answer:

Unemployment rate is the short answer. Yes, unemployment is a lagging indicator. That is because the last thing businesses want to do is hire more people even after the economy improves. Once a business has figured out how to operate lean and mean, they tend to want to stay that way for as long as possible. That is why the unemployment rate often continues to rise even after the end of a recession has been called. I point this out because **the cost of labor, for most businesses, is their biggest expense.** The Employment Cost Index (as reported by the U.S. Department of Labor's Bureau of Labor Statistics) has recently shown a sharp decline in the rise of pay for civilian workers. (*See comments below – U.S. Dept of Labor) **With the staggeringly large pool of available workers who are unemployed, wage push inflation is very likely to remain below historical trends for years to come.** This advantage (for businesses) far outweighs the negatives of inflation in energy, metals, foods, and other commodities. In previous “jobless” recoveries, like the current situation we may be in (I believe we are), inflation and interest rates remain relatively low (even the 10 year Treasury bond at 5.00% is considered by many to be historically low) for lengthy periods of time. An example of this would be the 1990's. What followed was a long lasting rise in equity and real estate prices. Keep in mind that the 1990's were marked with political uncertainty (President was impeached), massive turbulence in emerging markets (the Thailand currency, the Baht, collapsed sparking a collapse in emerging Asian economies), the Russian economy failed, and the world's biggest hedge fund collapsed, nearly bringing down the entire global financial system. Yes, the 1990's were kind to investors, but it wasn't so easy to see that until the decade ended.

Over-the-year changes, not seasonally adjusted

Compensation cost increases for civilian workers for the year ended March 2009 slowed dramatically, increasing 2.1 percent, down from the 3.3 percent increase for the year ended March 2008. In private industry, compensation costs rose 1.9 percent in the year ended March 2009, significantly less than the increase for the year ended March 2008, which was 3.2 percent. For state and local government, the increase for the 12-month period ended March 2009 was 3.1 percent, also slowing down from the March 2008 increase of 3.6 percent. Wages and salaries for civilian workers increased 2.2 percent for the 12-month

period; down from the March 2008 increase of 3.2 percent. Private industry wages and salaries decelerated to a 2.0 percent increase for the year ended March 2009. In March 2008 the increase was 3.2 percent. State and local government wages and salaries increased 3.0 percent for the year ended March 2009, slowing less dramatically than in private industry. The increase for the 12-month period ending March 2008 was 3.5 percent. Benefits increased 2.0 percent for civilian workers. In private industry, benefit costs increased 1.6 percent, much less than the increase for state and local government, which was 3.4 percent for the 12-month period ended March 2009. (<http://www.bls.gov/news.release/eci.nr0.htm>)

Number 2 answer:

We should listen to those who are in control of big money and to those who are in the position to grow their business via acquisitions.

For the week ended June 3, 2008, there was \$3.764 Trillion in money market funds, according to ICI (Investment Company Institute, <http://www.ici.org/>). Granted, not all of this money will work its way into investments, but this represents a substantial amount of new money that may potentially move into stocks, bonds, and real estate. There was a drop in this figure by \$25.22 Billion from the week before. Of this amount, \$15.41 Billion was institutional money, which is typically “solid and long term” money. And even if institutional money, which dominates the stock and bond markets, is wrong, no matter – it controls the market nonetheless. For this same week, \$13.60 Billion went into mutual funds. This comes after a massive net outflow out of equity mutual funds over the last 18 months. **Institutional money managers clearly see reason to put at least some money back into financial assets.** On a side note, the ICI reports money market fund assets to the Federal Reserve every week.

In a recent article (November 19, 2008), I wrote that one sign of a turn for the better in both the economy and the stock market would be if we saw an uptick in mergers and acquisitions activity. Clearly, we are seeing this now. Also, we just witnessed about \$75 Billion in new stock issuance (money raised) by U.S. banks as part of their requirements from the recent bank stress tests. This was PRIVATE sector money – not Gov’t or Gov’t backed money. This does NOT include the \$50+ Billion preferred equity conversion recently performed by Citigroup. Acquisitions have been pouring on strong as of late and I expect this trend to gain more momentum as the year goes on. In areas such as tech, pharma/biotech, and financial services, we’ve seen most of the activity.

Number 3 answer:

First, **investors are ill advised to attempt to squeeze every potential penny of profit out of this current rally.** No doubt, we’ll have another correction. The fact that so many pundits are vociferously calling for one makes me think we have a little more room to the

upside...subject to change at any time. Taking a little profit is not only prudent, but necessary if one is to have any cash to invest for the next correction.

Areas of interest first and foremost are the sectors/companies that have strong prospects for earnings growth over the next 3 years. Currently, year over year earnings will still come in negative, but that will most likely continue to be dismissed by investors. We all know that in the world of BL and AL (before Lehman and after Lehman); we need a new starting point from which we can judge corporate health. Beginning next September, we should see substantially improved year over year comps. That is generally a positive for stock price appreciation.

Since companies are expected to avoid adding to their labor ranks, investments in productivity enhancing technology could increase substantially as a way to do more with fewer employees.

Consolidation is another theme that bodes well for investors. Fewer players in a particular sector typically mean higher potential returns for the remaining players.

In sum, we are in the longest recession since WWII. Whether or not one believes our economy is truly on the road to a sustained recovery, investors need to have one foot in and one foot out. **The real challenge is to tune out all of the noisy statistics and focus on the main themes of a period of low wage push inflation, a massive cash position on the sideline, increased productivity with fewer employees, and capacity reducing consolidation. Ultimately, this confluence of situations has historically been very favorable to investors.**

Thanks for reading this. Please forward this to anyone you know who may find it interesting. Please reply me if you'd like to comment.

Interested in becoming a client? Call me. Let's talk about it.

(Disclosure: This is solely MY opinion. Of course, you are welcome to share your opinions with me too. If you act on any of this without speaking to me first and you lose money, don't blame me. I may be wrong. I reserve the right to change my mind about any of this whenever I want and without warning. We're NOT totally out of the woods yet! Have a great day! ☺)

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